

IP 04-0742-C M/L Profitt v Mendoza  
Judge Larry J. McKinney

Signed on 11/23/04

**NOT INTENDED FOR PUBLICATION IN PRINT**

KIMBERLY K. PROFITT and  
TIMOTHY C. PROFITT,  
Plaintiffs,

vs.

JOSE MENDOZA, JR., and  
JILL M. MENDOZA,  
Defendants.

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1:04-cv-742-LJM-WTL

## I. BACKGROUND

Mendozas a second mortgage on the Property (the “Second Mortgage”) to secure repayment of the promissory note.

The Debtors filed their Chapter 13 case on February 14, 2003. In their schedules, they listed the Mendozas as holders of an \$18,000 unsecured claim. The Mendozas successfully opposed the Plan, alleging that the Property, based on a fair market value assessment, is worth more than the amount owed on the First Mortgage. The parties stipulated that the amount owed to Provident on the First Mortgage is \$103,248.73. The Bankruptcy Court found that the scenario fits squarely into Bankruptcy Code § 1322(b)(2) and the question was whether Section 1322(b)(2)’s antimodification provisions apply to the Second Mortgage.

The Bankruptcy Court found that the valuation of the property should be based on comparable sales of similar residences in the area, and found that the fair market value of the Property is \$117,000. Therefore, there is equity in the Property to support the Second Mortgage. Consequently, the Second Mortgage cannot be modified under Bankruptcy Codes 1325(a)(5) or 506(a) and the Debtors’ Motion to Strip the Second Mortgage was denied. The Debtors were ordered to amend their chapter 13 plan to provide for full payment of the Second Mortgage.

## **II. STANDARD**

When it reviews a decision of the Bankruptcy Court, the District Court acts as an appellate tribunal. Therefore, its review is governed by traditional standards of appellate review. Specifically, the Court “is constrained to accept the bankruptcy court’s findings of facts unless they are clearly erroneous.” *In re Excalibur Auto Corp.*, 859 F.2d 454, 457 n. 3 (7th Cir. 1988). *See also In re Fedpak Sys., Inc.*, 80 F.3d 207, 211 (7th Cir. 1996); *In re Longardner & Assocs., Inc.*, 855 F.2d 455, 459 (7th Cir. 1988). However, conclusions of law made by the Bankruptcy Court must be reviewed

*de novo*. See *Excalibur Auto Corp.*, 859 F.2d at 457 n. 3; *Longardner & Assocs., Inc.*, 855 F.2d at 459. And, where the challenged finding is a mixture of law and fact, the clearly erroneous standard is also applicable. See *Graham v. Lennington*, 74 B.R. 963, 965 (S.D. Ind. 1987). Keeping in mind that the Debtors have challenged only the Bankruptcy Court's legal conclusion as to the method utilized in valuating the Property, the Court will address the issue raised in the instant appeal.

### **III. DISCUSSION**

The Debtors raise the single question of whether real estate serving as collateral should be valued in terms of net liquidation value and not fair market value. The Bankruptcy Code provides:

#### **§ 506 Determination of Secured Status**

(a) An allowed claim of a creditor secured by a lien on a property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such a property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

11 U.S.C. § 506(a). The Debtors argue that the evaluation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property, and not based on comparable sales of similar residences in the area, as found by the Bankruptcy Court. Br. App. at 5. Further, that because the Debtors will retain the Property, that constitutes the "proposed disposition or use" of the Property, and therefore, a valuation based on what the Debtors would receive upon sale was improper. *Id.* The Debtors then assert that the net liquidation value of the property is what the Property would sell for at auction; between 85% and 90% of its fair market

value. Not unexpectedly, the Debtors argue that this net liquidation value is less than the stipulated amount owed on the First Mortgage, \$103,248.73.

The Court finds no basis for the Debtors' interpretation of § 506. The Debtors claim that an "abundance of cases" hold that collateral is to be valued in terms of net liquidation value, not fair market value. *Id.* at 6. In Chapter 13 cases, Seventh Circuit bankruptcy courts value real property according to fair market value principles. *See, e.g., In re Demoff*, 109 B.R. 902, 903 (Bkrcty. N.D. Ind. 1989); *In re Zersen*, 189 B.R. 732, 738 -739 (Bkrcty. W.D. Wis.1995) ("There are three generally recognized appraisal techniques available to determine the fair market value of real property. First, there is the market or sales comparison approach, which is based upon evidence of comparable sales. Second, there is the cost or land development approach, in which actual costs of construction are reduced for depreciation. Third, there is the capitalization of income approach, which capitalizes the net future income that the property is capable of producing.").

What sparse authority the Debtors cite is not from this jurisdiction, nor binding on the Court. Moreover, the case that serves as the cornerstone of the Debtors' argument, *In re Robbins*, 119 B.R. 1 (Bankr. D. Mass. 1990), a Chapter 11 case, was squarely rejected by the First Circuit Court of Appeals in *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 75 (1st Cir.1995). The *Winthrop* Court explained: "The interpretation championed by [a line of cases, *Robbins* among them,] renders the second sentence of § 506(a) virtually meaningless. Moreover, it would allow a reorganizing debtor to reap a windfall by stripping down the lien to liquidation value and quickly selling the collateral at fair market value, thus pocketing equity that would have been completely beyond reach save for the filing of the bankruptcy petition." *In Re Winthrop*, 50 F.3d at 76 (*citing Butner v. United States*, 440 U.S. 48, 55 (1979) (bankruptcy law should "prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy") (internal quotation omitted)).

Following the Debtors' net liquidation valuation approach to its logical conclusion, the Debtors' Property would be valued at well under \$100,000, thereby rendering the Second Mortgage unsecured. They would then be able to turn around and sell the Property at fair market value, in this case \$117,000, pocket the equity, and thereby receive an impermissible windfall.

Having determined fair market value as the proper valuation method, there is equity in the Property to support the Second Mortgage. This Court agrees with the Bankruptcy Court that the Second Mortgage cannot be modified under Bankruptcy Code § 1325(a)(5) or 506(a). Further, the Debtors' Motion to Strip Second Mortgage was properly denied, and the Mendozas' objection to confirmation was properly sustained. The Debtors shall be given twenty (20) days from the date of this Order to amend their Chapter 13 plan to provide for full payment of the Second Mortgage.

#### **IV. CONCLUSION**

Based on the foregoing, the Order of the Bankruptcy Court is **AFFIRMED**.

IT IS SO ORDERED this 23<sup>rd</sup> day of November, 2004.

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LARRY J. McKINNEY, CHIEF JUDGE  
United States District Court  
Southern District of Indiana

Electronically distributed to:

Lori Ann Torres  
SMART KESSLER & TORRES  
[ltorr23@aol.com](mailto:ltorr23@aol.com)

Emerito Franco Upano  
[upanolaw@wmconnect.com](mailto:upanolaw@wmconnect.com)